APPENDIX A.

STATUTES INVOLVED

Revenue Acts of 1928 and 1932.

SECTION 101. (*a*) *Tax in case of capital net gain:* In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, at the election of the taxpayer, be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain. * * *

(*c*) *Definitions:* For the purpose of this title—

(*c*) (1) "Capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921. * * *

(c) (6) "Capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain.

(*c*) (7) "Ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions.

(*c*) (8) "Capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included

in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

SECTION 102. *Sale of Mines and Oil or Gas Wells.*

(*a*) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.

(*b*) For limitation to 12½ per centum rate of tax, see section 101.

Revenue Act of 1934.

SECTION 117. (*a*) *General Rule:* In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(*b*) *Definition of Capital Assets:* For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(*c*) *Determination of Period for Which Held:* For the purpose of subsection (*a*)—

(*c*) (1) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(*c*) (2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

APPENDIX B.

"*G. C. M.* 22730, 1941-26-10755 (p. 3).

Internal Revenue Code and Prior Revenue Laws.

(*Oil and gas leases: Tax status.*) *Status of oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.*

See Sec. 19.23(m)-1 at 411 CCH P227-240.

An opinion is requested with respect to the status of oil and gas leasing transactions for Federal income tax purposes, the acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

The following supposititious case presenting the questions involved may be stated for convenient consideration. A, as a fee owner of oil lands, leased the lands to B in consideration of a cash payment of $100,000, an additional $100,000 payable out of one-sixteenth of the oil and gas if, as, and when produced, and a one-eighth royalty interest. B then assigned his leasehold interest to C in consideration of a cash payment of $200,000, and an additional $100,000, payable only out of one-sixteenth of the oil and gas if, as, and when produced. C assigned one-half of the lessee interest to D, who agreed to

develop and operate the property, to advance C's share of the funds necessary for development costs and operating expenses, to sell all the oil produced and saved and credit C with one-half of the proceeds until all advances were fully recouped, and thereafter to operate the property and pay one-half of the proceeds from the sale of all oil produced, less one-half of the operating expenses, to C, who was not personally liable for any costs or expenses incurred or advances made. E drilled an oil well under an agreement with D entitling E to have delivered to his credit one-eighth of all the first oil and/or gas if, as, and only when the same is produced, saved, and marketed from the land until he received the sum of $25,000. Also, F paid D the sum of $15,000, which D covenanted to use in developing the property, and D agreed to pay F the sum of $25,000, payable out of one-eighth of the oil and/or gas if, as, and only when the same is produced, saved, and marketed from the leased land.

In *Lynch v. Alworth-Stephens Co.* (267 U. S., 364, T. D. 3690, C. B. IV-1, 162 (1925) (1 USTC P 117, 5 USTC P 1615) and cases therein cited, the United States Supreme Court, though it expressly recognized the hardship involved in treating all proceeds from the extraction and sale of ore as ordinary income in view of the fact that mining operations reduce the value of property interests in mineral deposits, made it clear that such reduction in value is not depreciation but depletion, and that the capital investments in minerals of both the lessor and the lessee are returnable to them tax-free only through

depletion deductions expressly granted by statute. (See also *Helvering v. Mountain Producers Corporation,* 303 U. S. 376, *Ct. D.* 1321, C. B. 1938-1, 343 (38-1 USTC P 9153), wherein the Court stated that the depletion allowance rests upon legislative grace.)

Though the Revenue Act of 1916 did not expressly provide for the allocation of depletion between the parties in interest, the Court in the Alworth-Stephens case regarded both the lessor and lessee of mining property as owning valuable property rights in the mineral in place which were reduced in value through the extraction of ore, and it held the total depletion allowable was allocable between the lessor and the lessee in proportion to the interests of each severally considered.

Subsequent decisions hold that the incidental exhaustion of natural deposits through the production and sale of oil or minerals is not a sale or conversion of capital assets allowing cost or basic value to be recovered tax-free. Further, a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed (hereinafter referred to as a "bonus") and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold (hereinafter referred to as "royalties") which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation. (See *Bankers Pocahontas Coal Co. v. Burnet,* 287 *U. S.,* 308, *Ct. D.* 618, C. B. XXII-1, 272 (1933) (3 USTC P 998, and

Burnet v. Harmel 287 *U. S.*, 103, *Ct., D.* 611, C. B. XI-2, 210 (1932) (3 USTC P 990), involving ordinary royalties paid a lessor of coal lands on the basis of a fixed amount per ton mined, and a bonus paid the lessor of oil lands, respectively.) The Court thus not only recognized that royalty payments like rental payments are ordinary income to the lessor, but drew an analogy between cash bonus payments made upon the execution of an oil and gas or mining lease and a substantial payment received in the first year by a lessor in any other type of lease for purposes of classifying such bonus payments as ordinary income rather than proceeds from the sale of capital assets.

Such classification of bonus payments does not depend upon whether the local law regards the agreement between lessor and lessee as a lease or a sale of natural resources in place. In *Palmer v. Bender* (287 *U. S.*, 551, *Ct. D.* 641) C. B. XIII-1, 235 (1933) (3 USTC P 1026) the Court refused to distinguish between lessors and sublessors or assignors of leasehold interest who, by stipulation for royalty payments, reserve an interest in production coextensive with the leasehold life. The taxpayer therein was a member of several partnerships, each of which had acquired an oil lease, had discovered oil, and had then assigned the lease to a third party in consideration of a bonus payment, a future payment of a stated sum to be made out of one-half of the first oil produced and saved (which type of payment will hereinafter be referred to as an "oil payment"), an interest which does not by its terms

extend throughout the lease life, and an additional "excess royalty" of one-eighth of all of the oil produced and saved. The Court held that the bonus payment, the oil payments, and the royalty payments were ordinary income to the sublessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. The Court refused to distinguish between leases governed by varying State laws which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases—i. e., the value of his interest is lessened by the extraction of oil. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion provisions are applicable, the language of the statute, providing that the depletion allowance shall be allocated between lessor and lessee, being held to be broad enough to provide, at least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital. The opinion states that a lessor, or sublessor or assignor, who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil and gas in place entitling him to depletion deductions against cash

bonus payments as well as proceeds from his share of the oil. The opinion implies that the proceeds from the sale of any share in the oil produced are income subject to depletion in the hands of the one entitled to such share. Further, the Court speaks of the oil and gas in place as a reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.

Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. If the lessee in turn subleases or assigns the working interest, reserving a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the

view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him. Thus, in the classification of royalty payments as "rent" to the lessor, the term is employed as denoting a sharing by the lessor for the use of his land rather than as an amount owing and paid by the lessee. A cash bonus, though termed an advance royalty payment, paid to a lessor without regard to production and often in a year when there is no production, is not a division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset to a lessor reserving a royalty interest. The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property.

The analogy between the bonus payment accompanying a mineral lease and a large payment made in the first year of any ordinary lease, to which the Court resorted to characterize the bonus payment as ordinary income as distinguished from capital gain to the lessor, does not establish an identity of character in the two types of payments for Fed-

eral income tax purposes. An oil or mineral lease differs from an ordinary land lease in that it contemplates severance and disposition of valuable mineral deposits that normally represent a large percentage of land values. Further, the allowance of depletion deductions to the lessor, which serve to offset his bonus income and reduce the basis of his interest, establishes the distinction between such payments by treating the bonus payment upon an oil or mineral lease as, in part, a tax-free return of the lessor's capital investment in mineral in place. As the mineral in place is the reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, it follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.

It will be noted that the analogy between a bonus payment made upon the execution of an oil or mineral lease and a large rental payment made in the first year of any ordinary lease, upon which the Supreme Court based its conclusion that such bonus payment was ordinary income in the nature of an advance royalty payment subject to the depletion allowance rather than proceeds from the sale of a capital asset, is not available to permit of like treatment of a cash payment made where no royalty right is reserved by the payee. Royalty rights represent a share in all of the oil or mineral in place, and a bonus payment which reduces the royalty and, therefore, the lessor's capital interest in every unit of oil or mineral content may properly be termed an advance royalty. Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him. (See Commissioner v. Fleming, 82 Fed. (2d), 324 (36-1 USTC P 9165).)

It thus appears that (1) agreements to pay royalties measured by a fraction of the mineral product or the proceeds therefrom, or by a stated sum per unit extracted and sold, in effect divide the pro-

ceeds from production, and (2) cash bonus payments representing advance royalty payments effect a substitution in the reservoir of capital investments of lessee invested capital for invested capital withdrawn by the lessor in the amount of depletion sustained by him, thereby giving the lessee a larger share upon production and, consequently, a greater interest in natural deposits in place than he would have had if there had been no cash bonus payment. A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.

The stated basic concepts of income and the attending depletion allowances apply to depletion provisions basing allowances on percentages of gross income from the properties as well as to the provisions of the earlier Acts granting allowances based upon cost or value at March 1, 1913, or upon discovery value. In *United States v. Dakota-Montana Oil Co.* [288 *U. S.*, 459, *Ct. D.* 655, C. B. XII-1,243 (1933)] (3 USTC P 1067), treating capitalized intangible costs of development as returnable through the depletion allowance, the Court pointed out that there is "no ground for supposing that Congress by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance." The Court said that the "reasonable inference is that it

did not and that depletion includes under the 1926 Act precisely what it included under the earlier Acts." In *Herring v. Commissioner* [293 *U. X.*, 322, *Ct. D.* 904, C. B. XIV-1,303 (1935)] (35-1 USTC P 9012) the Court stated that the nature and purpose of the allowance based on a percentage of income are the same as in the case of the allowance based on cost, and allowed a lessor receiving an advance royalty or bonus payment upon the execution of an oil and gas lease a percentage depletion allowance thereon. The fact that such an allowance is in anticipation of production was stated to be no more persuasive under the percentage depletion provisions than it was under the depletion provisions of the earlier Acts.

Aside from such bonus payment to a lessor or assignor, the term "gross income," as used in the phrase "gross income from the property" in the percentage depletion provisions, means the same as "gross income" in the provisions generally defining income, with the qualification that the phrase "gross income from the property" in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses. [See *Helvering v. Twin Bell Oil Syndicate,* 293 *U. S.*, 312, *Ct. D.* 905, C. B. XIV-1, 253 (1935)] (35-1 USTC P 9014), involving an assignee of an oil and gas lease which was obligated to pay royalties in cash or in kind totaling one-fourth of the oil extracted.) The taxpayer-assignee in *Helvering v. Twin Bell Oil Syndicate supra,* contended that the entire gross income from

production of oil and gas was its gross income from the property and claimed the deduction of 27½ per cent thereof as its allowance for depletion. The Court held that the income from production and sale of the products and the depletion allowance thereon, however measured, must be apportioned between lessor and lessee. Thus the Court confirmed the implications of the earlier cases involving lessors and sublessors or assignors by applying the basic concepts as to (1) gross income from production, and (2) depletion allowances and their division between the respective parties interested.

In the last-cited case the Court, in effect, pointed out that an agreement to pay royalties represents a sharing arrangement between the parties by expressing the view that the provision of a later Act, section 114(b)3, Revenue Act of 1932, which expressly excludes royalties paid or incurred in respect to the property from the lessee's gross income from the property, was merely declaratory of existing law. This implication as to division between the parties by means of royalty payments was confirmed and extended to include divisions effected by agreements to make oil payments in *Thomas v. J. J. Perkins et al.* (301 *U. S.*, 655, *Ct. D.* 1237, C. B. 1937-1, 162) (37-2 USTC P 9315), wherein proceeds from the share of oil reserved by an assignor were held not to be income to the assigne. In that case, lessees of oil and gas leases assigned the leases for $395,000, payable out of one-fourth of the oil produced free of any share of development expense or any other burden. The *Palmer* case, *supra,* was cited as sup-

porting the view that the oil payment interest retained by the assignors gave them ownership of the stipulated share of the oil and entitled them to the income therefrom and the depletion allowance thereon. The *Twin Bell Oil* case, *supra*, was cited as holding that it is immaterial whether the lessor, or sublessor or assignor, is to receive the royalty in oil or the proceeds from the sale of his share of such oil by the lessee.

The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas. Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules. The parties entitled to share in oil or mineral extracted or the gross proceeds therefrom (including the parties to a lease providing for royalty payments of stated amounts per unit mined), have economic interests in the oil or minerals in place. That is, they, as owners of the rights in oil or other mineral in place, share the income from production, and the depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights. (See also the *Mountain Producers* case, *supra*, wherein the royalty payable by the producer was measured by a per unit price based on current gasoline prices.)

It will be noted that the persons entitled to oil payments or royalty payments, which the above-cited cases have characterized as the owners of economic interests in oil or mineral in place, by the terms of the agreements from which these rights

arise, are assured of a share if there is production of oil or mineral. *J. Steve Anderson et al. v. Helvering* (310 U. S., 404 Ct. D. 1456, C. B. 1940-1, 108) (40-1 U. S. T. C. P. 9479) confirm this view. The obligation there involved was not an ordinary oil payment right, as it was payable out of proceeds from oil produced or proceeds from resale of the properties. Payment out of proceeds from resale would liquidate the obligation and terminate the right to share in production income.

Assurance of a share upon production marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others. The right to share in production or gross income therefrom should not be confused with a contractual right to purchase and process a product of the mine or well, even though such processing incidentally aids production and is done under a sharing of the processed product with the producers. In *Helvering v. Bankline Oil Co.* (303 U. S. 362, Ct. D. 1323, C. B. 1938-1, 306) (38-1 U. S. T. C. P. 9154) the taxpayer contracted with producers of oil and gas for the treatment of wet gas to produce gasoline. The taxpayer agreed to install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, and the producers agreed to deliver the natural gas from which the taxpayer was to extract the gasoline and return part of the dry gas to the well to be used therein for pressure purposes. The taxpayer agreed to deliver

one-third of the gasoline extracted or the gross proceeds from the sale of such share. The Court held that the taxpayer was a mere purchaser of the gas produced from the well and not a producer of gas having a depletable economic interest in mineral in place. It should be noted that the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas, but the processing of gas. The *Mountain Producers* case, *supra,* is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place.

Similarly, a right to share in production, or the gross income therefrom, is very different from the right to share in the net income of the producer (a right measured not by production of mineral, as such, but by the degree of success in operation of such a right owned by another). [See *Helvering v. Elbe Oil Land Development Co.,* 303 U. S. 372, Ct. D. 1322, C. B. 1938-1, 293 (38-1 U. S. T. C. P. 9155), as interpreted by the *Anderson* case, *supra,* and *Helvering v. O'Donnell,* 303 U. S. 370, Ct. D. 1324, C. B. 1938-1, 337 (38-1 U. S. T. C. P. 9156).] In the *Elbe* case, *supra,* the rights in oil properties and equipment were transferred for a stated consideration payable in annual installments, irrespective of production from the properties transferred, plus one-third of the net profits derived from operation of the properties by the purchaser after it had been

reimbursed from oil and gas proceeds for all expenditures made by it in the acquisition, development, and operation of the properties. The interest of the seller was thus limited to a right to share in net income after recoupment of capital expenditures rather than gross proceeds from production. In the *O'Donnell* case, *supra,* stock of a corporation owning oil property rights was sold to another corporation (which was to take over in liquidation the oil properties of the first corporation and operate them) for a one-third share of the net profits derived from the operation of the oil properties. In both cases, the Court held the transfers to be sales, and that in neither case did the transferor have a depletable economic interest in the mineral in place after the transaction had been completed.

It seems clear that the right to share in production, or the gross proceeds therefrom, which distinguishes ownership of depletable economic interests in oil or mineral in place from non-depletable economic advantages, including contractual rights to purchase the product or to share in net income, does not depend upon legal title to the oil and gas or mineral deposits. (*Burnet v. Harmel, supra,* and *Palmer v. Bender, supra.*) Also, as noted above, in the *Palmer* case, technical legal description or characterization of the right was treated as immaterial, the Court saying that the owner of a depletable economic interest includes any taxpayer who "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must

look for a return of his capital." In the *Anderson* case, *supra,* the Court, in discussing the *Perkins* case, *supra,* involving an oil payment right reserved upon assignment, said the "decision did not turn upon the particular instrument involved, or upon the practical consequences of the provision for payments of that type."

Such language seems as applicable to grants as to reservations of economic interests, as the formalities of the conveyancer's art are quite as exacting in the reservation of interests as in the grant of interests. If, as the Court indicates, the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts, in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitling one making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The lessor or assignee, like the lessor or assignor who retained

a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished. Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property, is distinguishable from a sale the proceeds of which are uniqualifiedly received by the seller. This view seems to accord with the realities of such transaction. In none of such cases has

the lessee parted with a capital asset, and the investments involved are not his investments.

The stated principles seem applicable irrespective of whether there are words purporting to convey an interest in the oil in place involved in the oil payment rights. Both the practical and economic consequences of provisions for payments of this type are identical in either case. It seems generally agreed that, irrespective of conveyancing formalities, a right to a share of the oil produced carries with it a corresponding interest in the oil in place. That rights to share in the oil produced are analogous to rights to share in gross proceeds derived from the sale of oil produced has been repeatedly stated by the highest court. It would seem to follow that a right to a share of the proceeds from the sale of oil produced would give the payee ownership of a corresponding depletable economic interest without regard to conveyancing formalities.

It thus appears that the controlling cases regard capitalized development costs as representing investments returnable through the depletion allowances, whether the total development investment is made by a landowner who elects to develop the property himself and take all the oil or mineral or is shared by a number of investors who, by contractual arrangements between themselves, agree to divide the resulting oil or mineral product or the proceeds from the sale of such product. If the latter, the division of oil, or the gross income therefrom, determines the economic ownership of oil or mineral in place as well as the gross income and attending de-

pletion allowances. Under this test, the form of the contracts dividing the product or the gross income therefrom, or the legal phraseology or devices utilized to accomplish the division, are immaterial. For example, an instrument purporting to be a "lease" of oil or mineral lands, which gave a "lessee" a right to explore for and produce all the oil or mineral found thereon and required the "lessee" to pay the "lessor" only a share of the net profits derived from the operation (as distinguished from a share of the product or the proceeds from the sale of the product), would leave the "lessor" without a depletable economic interest in the oil or mineral in place, and a "bonus" payment, if any, made upon the execution of such instrument would represent proceeds from the sale of a capital asset. Such results accord with the realities of the test supplied. Under such an agreement, the lessee may exhaust a substantial oil or mineral content with little or no realization of net profits, in which event the lessor will receive little or nothing under the contract. That being true, the lessor in effect has not retained an interest in the oil or mineral content.

Similarly, the Federal income tax status of a "carried interest" depends upon the extent to which such interest in effeect represents a right to share in gross income as distinguished from net income derived from the operation. In *Reynolds v. McMurray* [60 Fed (2d) 843, certiorari denied 287 U. S. 664, *Ct. D.* 616, C. B. XXI-1, 198 (1933)], McMurray was the owner of an undivided interest in oil leases, subject to a contract with the Ohio Oil Co., which

also owned an undivided interest in such leases. Under the contract, the parties agreed that the Ohio Oil Co. was to manage, control, develop, and operate such leases and pay all costs incident thereto, and charge McMurray's undivided interest with its proportionate part thereof; that it should market the oil and gas produced and account to McMurray for his proportionate part thereof; that it should be reimbursed by McMurray from the proceeds derived from the sale of his proportionate part of the oil and gas, to be effected by crediting McMurray's account with the Ohio Oil Co., on the first of each month, with the proceeds derived from the sales during the month preceding of his proportionate part of the oil and gas; and that it should make monthly remittances to him of his proportionate share of any proceeds remaining after deducting the amounts due it for expenditures made by it for him.

The economic or practical effect of such contract was to turn over the leasehold estate to the Ohio Oil Co. for development and the extraction and sale of the product. Though McMurray retained legal title to his undivided interest under the lease, he contracted away the only right granted thereby, *i. e.,* to extract and sell the oil content of the leased land. Thereafter, the development and operation of the property were carried on by the oil company on its own behalf and not as a joint operation by co-owners. Proceeds from the sale of oil were not divided between the parties. Charges and credits in the account between the parties did not reflect actual obligations between them. Rather, they were merely

factors in computing the net income payments which were all McMurray could ever become entitled to under the agrement, regardless of how much oil was extracted and sold from the leased premises. McMurray's interest was converted into a mere contractual right to share in any net income derived from the sale after recoupment of all capital invested by the oil company. The oil company was obligated to make all of the investment necessary to develop the property and to pay all the cost of operation, and it could look only to the proceeds from the sale of the lessee share of oil and gas produced for reimbursement of its capital expenditures and operating expenses. The oil company assumed all the risks and burdens attending development and operation, and it was entitled under the contract to the entire lessee share of production which was the only source from which its capital and expenses could be recouped. Accordingly, such investment was in an economic interest in oil and gas in place measured by the lessee share of production. It is, therefore, the opinion of this office that the decision in that case, holding that the proportionate share of the proceeds from the sale of oil ostensibly credited to McMurray was constructive income to him, is out of harmony with the above-described test of ownership of income from production, and it should no longer be followed. In cases where, after recoupment of such charges or so-called advances to the "carried interest," the interest ceases to be a "carried interest" and the owner thereof becomes entitled to a share in the oil, or the gross income therefrom, and

liable for his share of costs and expenses, he should be regarded as retaining under the contract an economic interest in oil in place, consisting of his undivided interest in the lease less the right of recoupment, which is comparable to an oil payment right, carved out of his fractional working interest.

The questions presented by the supposititious case stated herein are answered generally by the above discussion. Specifically, A, the fee owner, realized $100,000 bonus income when the lease was executed. He also realizes as income one-sixteenth of the proceeds from production until that fraction produces $100,000, and one-eighth of such production as royalty income so long as production continues. All of such income is ordinary income. He is entitled to corresponding depletion allowances, and suffers reductions in the bases of his oil payment and royalty interests reseulting from such depletion deductions. A lessee who subleased or assigned his interest for like consideration would occupy a comparable position. The $200,000 which C paid to B was consideration for the sale of B's interest, less the retained oil payment of one-sixtenth interest until $100,000 is produced. B is not entitled to depletion on the $200,000 cash payment, but he is entitled to depletion on such retained interest. By the "carried interest" arangement between C and D, the former converts a depletable economic interest in oil in place into a non-depletable contractual right to share in D's net income after recoupment by D of all development costs and expenses. Had C received a cash payment, it would have represented proceeds real-

ized upon the sale of a capital asset by him. E, irrespective of words purporting to convey ownership of oil in place, acquired a depletable economic interest to the extent of his oil payment right for a capital investment measured by the expenditure made by him in drilling and equipping the well. F acquired a like interest for the $15,000 furnished by him to D for development purposes. His interest would have been the same had D not been pledged to expend the $15,000 for development. In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss. D, of course, acquired an economic interest consisting of the seven-eighths working interest, less the oil payment rights agreed upon by him or his predecessors and held by A, B, E, and F. His (D's) invested capital account does not include the investment sums contributed by E or F under their contracts with him, but it does include the amount "advanced" by him for C's share of capitalized development cost. (Signed by J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.)"